

Reference: 20160376

25 January 2017

Thank you for your Official Information Act request, received on 26 October 2016. You requested the following:

“Can you please provide a copy of the 18 April 2016 Treasury Report entitled ACC & NZSF – Responsible Investment Frameworks.”

On 23 November 2016 the deadline to respond to this request was extended by 30 working days.

Information Being Released

Please find enclosed the following documents:

Item	Date	Document Description	Decision
1.	18 April 2016	Treasury report: ACC & NZSF – Responsible Investment Frameworks.”	Release in part

I have decided to release the document listed above, subject to information being withheld under one or more of the following sections of the Official Information Act, as applicable:

- personal contact details of officials, under section 9(2)(a) – to protect the privacy of natural persons, including deceased people,
- commercially sensitive information, under section 9(2)(b)(ii) – to protect the commercial position of the person who supplied the information, or who is the subject of the information, and
- information subject to an obligation or confidence, under section 9(2)(ba)(i) – to protect any person who has been or could be compelled to provide information under the authority of any enactment, where the making available of the information would be likely to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied.

Please note that while the report has referred to material provided by the Accident Compensation Corporation (ACC) and the New Zealand Superannuation Fund (NZSF), it represents Treasury analysis and does not reflect the views of ACC or NZSF.

NZSF's CIV policy has been amended since the time of writing (see Paragraph 32). NZSF's policy now states that "We endeavour to apply exclusions to Collective Investment Vehicles (CIVs), to the extent this is feasible and commercially prudent. CIVs are evaluated on a case-by-case basis. The potential for indirect exposure to excluded securities through CIVs is factored into the selection of access points".

In making my decision, I have considered the public interest considerations in section 9(1) of the Official Information Act.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This fully covers the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Craig Weise
Manager, Commercial Operations – Strategy and Policy

Treasury Report: ACC and NZSF – Responsible Investment Frameworks

Date:	18 April 2016	Report No:	T2016/680
		File Number:	CM-1-3-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Note the contents of the report	None
Minister for ACC (Hon Nikki Kaye)	Note the contents of the report	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
s9(2)(a)	Analyst, Commercial Operations – Strategy and Policy	s9(2)(a)	N/A (mob)
Shelley Hollingsworth	Senior Analyst, Commercial Operations – Strategy and Policy	04 890 3593 (wk)	✓
Craig Weise	Manager, Commercial Operations – Strategy and Policy	04 917 6149 (wk)	

Actions for the Minister’s Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: ACC and NZSF – Responsible Investment Frameworks

Purpose of Report

1. This report provides a high level comparison of the approach to ethical investment that is taken by each of the New Zealand Superannuation Fund (NZSF) and the Accident Compensation Committee (ACC) (together, the Funds). The report has been drafted in light of the Official Information Act request by Mr. Ashe (dated 25 November 2015) and ACC's subsequent response (dated 5 April 2016), regarding ACC's investment in Collective Investment Vehicles (CIVs).
2. Particular focus has therefore been given to how each fund faces the challenge of ensuring ethical investment when investing through CIVs. Some thought has also been given to the potential financial implications of implementing a divestment standard for CIV investments under the Responsible Investment Frameworks of the funds.

Statutory Mandates and Ethical Investment

3. This section reviews the mandates that govern the NZSF and ACC as legislated in the New Zealand Superannuation and Retirement Income Act 2001 (Super Act) and the Accident Compensation Act 2001 (ACC Act).

NZSF

4. Section 58 of the Super Act states that the Guardians of New Zealand Superannuation Fund (the Guardians):

"...must invest the Fund on a prudent, commercial basis and, in doing so, must manage and administer the Fund in a manner consistent with –

- *best-practice portfolio management;*
- *maximising return without undue risk to the Fund as a whole; and*
- *avoiding prejudice to New Zealand's reputation as a responsible member of the world community."*¹

Each of these three legs is taken into account when considering investment issues, with none taking precedence over the other.

5. NZSF's Responsible Investment Framework is consistent with this mandate and incorporates 61(d) and (i) under the Act:
 - *"ethical investment including policies, standards, or procedures for avoiding prejudice to New Zealand's reputation as a responsible member of the world community;" and*
 - *"the retention, exercise, or delegation of voting rights acquired through investments."*²

¹ New Zealand Superannuation and Retirement Act 2001, section 58(2)

² New Zealand Superannuation and Retirement Act 2001, section 61(d)(i)

ACC

6. ACC's investments are governed by the ACC Act. Section 271 of the ACC Act states that ACC's investment statement:
- *"being a statement of policies, standards, and procedures...must include a statement relating to ethical investment for avoiding prejudice to New Zealand's reputation as a responsible member of the world community."³*

The ACC Act goes on to state in Section 275 that:

- *"...the Corporation must invest, in the same manner as if it were a trustee..."⁴*
7. In conducting its investment activities, ACC must always act in a manner that is consistent with its statement relating to ethical investment and with its obligation to invest as if it were a trustee, which is taken to imply a fiduciary obligation to maximise long-term risk adjusted net returns.

Commentary

8. In each case, the funds are required to **balance** their duties to make **ethical investments** with their **fiduciary duties** to maximise long-term risk adjusted returns. The legislation does not provide specific guidance as to what the relevant terms in these mandates mean, with interpretation left up to the respective Boards of ACC and the Guardians. The statutory mandates are then reflected, along with ministerial directives, in the investment constraints, guidelines and policies which are established by the Boards.

Other Relevant Legislation and Treaties

9. In developing a Responsible Investment Framework, ACC and NZSF are also impacted by the following statutes:
- New Zealand Nuclear Free Zone, Disarmament, and Arms Control Act 1987;
 - Cluster Munitions Prohibition Act 2009; and
 - Anti-Personnel Mines Prohibition Act 1998.

In conjunction with the following treaties:

- South Pacific Nuclear Free Zone Treaty;
- Convention on Cluster Munitions;
- Ottawa Mine Ban Treaty; and
- International Convention for the Regulation of Whaling.

³ Accident Compensation Act 2001, section 271 (3A)(c)(v)

⁴ Accident Compensation Act 2001, section 275(1)

Ethical Investment Policy

10. Both the NZSF and ACC are signatories to the United Nations Principles for Responsible Investment (UNPRI)⁵ and the UN Global Compact,⁶ and are engaged with several other relevant international investor groups working to help deliver better environmental, social and corporate governance (ESG) outcomes.
11. International conventions, New Zealand law, Crown actions, and companies' involvement and activities, are key factors in the Guardian's decision-making process around NZSF's ethical investment responsibilities. The key policy document adopted by the Guardians is the NZSF's Responsible Investment Framework.
12. The ACC Board is guided by recent New Zealand and international laws, global ethical practices, its roles in the health sector and investment community, and its own views of ethical investing. The Board looks to the laws of New Zealand to be a reflection of those principles that are widely held by the New Zealand public. Changes to ACC's Ethical Investment Guidelines were approved by its Board on 31 March 2016. The update tightens the controls applicable to initiating and retaining an investment in a CIV.

Direct Investment

13. NZSF and ACC each have controls in place to ensure that they do not make any direct investments in companies that do not comply with their policies on ethical investment. At each fund, the two key principles for ensuring this compliance are **engagement** and **exclusion**.
14. To the extent that there is a portfolio company with operations or practices that are of some concern, it is the policy of both of NZSF and ACC to first **engage** with the company and attempt to influence an outcome. It is considered a last resort to place a company on a **Direct Exclusion List**, in which case divestment of any existing direct holding is required and any new directly-held positions will not be entered into.
15. The NZSF and ACC each maintain a Direct Exclusion List of companies that are engaged in the following:
 - manufacture of cluster munitions;
 - manufacture or testing of nuclear explosive devices;⁷
 - manufacture of anti-personnel mines;
 - manufacture of tobacco; or
 - processing of whale meat.
16. While there is a clear alignment between NZSF and ACC of these exclusions at a high level, the level of engagement that a company has in an excluded industry remains largely subjective and many factors must be taken into account in determining whether to exclude that company. As a result, the NZSF and ACC do not always make the same decisions regarding particular exclusions. In certain instances, ACC may give

Clarification paragraph 14: Paragraph applies to single name securities or sectors but not to category type exclusions such as cluster munitions where exclusion rather than engagement would take place.

⁵ www.unpri.org

⁶ www.unglobalcompact.org

⁷ ACC further specifies that it does not invest in companies that assemble or refurbish nuclear devices; NZSF further specifies that it does not invest in companies that operate nuclear military bases.

consideration to its role in Health when making subjective calls around some exclusions.

17. Neither of NZSF or ACC currently have an exclusion policy in place with regards to sugar.

CFI Service Sharing Agreement

18. In 2009 the Guardians signed an agreement with each of ACC and the Government Superannuation Fund Authority (GSFA) to collaborate and share resources on ethical investing issues. Under this agreement, the Guardians contract annually to provide support, information and analytical services on ethical investing to ACC and GSFA. In turn, the Guardians engage external specialist screening agencies to identify companies involved in excluded activities, and may also receive relevant information from other organisations with expertise in this field or from the companies themselves.
19. In practice, a key service provided by the Guardians is to investigate and recommend on ethical investment behaviour of various entities. Each entity must then make its own decision about which companies should be excluded from direct investment, and maintain their own separate Direct Exclusion Lists. ACC and GSFA do individually share their Direct Exclusion Lists with the Guardians, and there is an open dialogue between these entities about the various differences in position. However, each entity continues to retain responsibility for their individual ethical investment policies, decisions and compliance.

Clarification paragraph 19: NZSF maintains an exclusion list on behalf of GSFA

Use of CIVs

20. In a general sense, when we refer to a CIV in this report, we mean a collective investment fund that handles a pooled group of accounts. CIVs combine the assets of various individuals and organisations to create a large, well-diversified portfolio.
21. The degree of use of CIVs that is employed by ACC or NZSF will be driven by the investment style as well as the asset allocation strategies of the individual funds. A greater allocation to global equities has the potential to translate to greater use of CIVs by a fund. However, other tools such as segregated mandates or derivatives may be employed to reduce this exposure.

Correction paragraph 21: delete "or derivatives"

Approach to CIVs - NZSF

22. When using external managers, the NZSF uses a number of mechanisms to ensure that they can apply their Direct Exclusion List, including using segregated mandates. They also use Investment Management Agreements where the manager acts on NZSF's directions so they can apply their Direct Exclusion List. Under each of these arrangements, NZSF can ensure that any holdings that appear on its Direct Exclusion List are divested.
23. NZSF also makes investments through CIVs. In these cases there is potential for **indirect** exposure to excluded companies if they are in the underlying fund. By nature, as a pooled fund, a CIV services multiple investors and it may not be possible to impose NZSF's exclusions on the pool. Of note, the fund does not have any **direct** exposure to excluded companies through CIVs as it does not hold the underlying securities.
24. With regard to Private Equity (unlisted) CIVs, the risk of indirect exposure to excluded companies is either mitigated through the nature of the Private Equity fund mandate (eg, real estate or social infrastructure focus) or negotiation of a **side letter** which ensures no obligation on the fund for any capital call that breaches the policies of its Responsible Investment Framework.

25. Likewise, with most CIVs that have listed mandates, they are either not exposed to excluded activities (because they are confined to a specific asset class such as natural catastrophe insurance), or the investments are entered into via mandates that require the managers to apply NZSF's exclusions.

s9(2)(b)(ii) and s9(2)(ba)(i)

28. Over time, NZSF has reduced its use of CIVs, making increased use of derivatives and segregated mandates.

Approach to CIVs - ACC

29. ACC uses segregated mandates with a number of external managers as it is generally ACC's preferred form of management. In these cases, the portfolio of investments is held directly in ACC's name and subject to rules that have been negotiated with the manager, including adherence to ACC's Direct Exclusion List.

30. ACC also invests via CIVs where segregated mandates are not possible and as such it is possible that ACC may indirectly have exposure to an excluded company from time to time. ACC's ethical investment policy requires the existence of any such holding to be taken into account as a negative factor in deciding whether to initiate or retain an investment in a CIV. However, it will **not preclude** the ACC from investing or continuing to invest in the CIV. Other factors for evaluation include (but are not limited to) the ethical policies of the manager, the total proportion of funds invested in entities on ACC's Direct Exclusion List and whether the CIV has provided new capital or if the investment occurred due to secondary market trading.

31. Through periodic reporting, ACC became aware that one of its invested CIVs, Orbis Investment Management (Orbis), had acquired a stake in 2015 in the cluster munitions manufacturer Lockheed Martin. In line with ACC's policy of engagement, ACC has engaged with Orbis to reiterate its ethical investing exclusions and concerns. In determining that the indirect position in Lockheed Martin did not breach ACC's ethical investment policy, the following factors were considered:

Clarification paragraph 31: Lockheed Martin is an American global aerospace, defense, security and advanced technologies company. It is on ACC's exclusion list because of its involvement in the development or production of cluster munitions

- The holding in Lockheed Martin was indirect and ACC was unaware of the investment until after it had been acquired by Orbis;
- The purchase was done on the secondary market;
- The holding represented only 0.3% of the Orbis fund’s overall portfolio and has since been divested; and
- ACC has not invested in any CIV with the **intention** or **knowledge** that monies would be used in the development or production of cluster munitions.

Commentary

32. At face value there is some differential between the approach taken by NZSF and ACC in ensuring their ethical investing when using CIVs:

- NZSF: “we will **endeavour to ensure** that *Collective Investment Vehicles* we enter into **do not contain prohibited investments**; however we cannot usually apply such prohibitions to existing *Collective Investment Vehicle* investments”⁸
- ACC: “ACC must **take into consideration** the extent to which the manager of a CIV invests in a manner that is in line with or contrary to ACC’s ethical investing policy”⁹

33. However, in practice the policies do appear to be close in how they apply. s9(2)(b)(ii)
s9(2)(b)(ii)

s9(2)(b)(ii) Overriding this process is that each fund does need to consider their fiduciary duties to maximise risk-adjusted long term returns.

Financial Implications of Implementing a Divestment Standard for CIVs

34. Under the current policies of NZSF and ACC, there is already a real cost of applying the restrictions imposed by the Responsible Investment Frameworks. While the combined effect of **directly excluding** investments in companies involved in excluded activities may not be considered material at the fund level, continued exclusions, particularly of a growing number of the largest companies, could have a cumulative and potentially more material impact on the respective portfolios.¹⁰

⁸ NZSF Risk Allocation Policy (10.4)

⁹ ACC Ethical Investment Guidelines (10.6.2)

¹⁰ NZSF report on Investment in Companies Associated with Nuclear Weapons (6.5.6.6)

Clarification paragraph 32: Note, the NZSF investment policy has been updated since this quote was published.

35. A stricter policy stance might involve the forced divestment of holdings in any CIV where it becomes known that the vehicle holds an investment in an excluded entity. The financial implications of such a stance could be much more material to the overall fund in question. The following potential financial implications of imposing such restrictions should be considered (among others):

- Exit Cost;
- Value Leakage; and
- Opportunity Cost.

Exit Cost

36. At face value, the actual cost of being forced to exit from particular investments in CIVs seems like it should be straight forward to quantify. At any point in time, one could consider the potential exit margins that would be charged upon withdrawal of funds, and apply this to the quantum of funds invested through CIVs.

37. While this may seem like a reasonable approach, it would in fact be a constantly moving target as the risk at any point in time will change depending on current asset allocation and implementation strategy. That is, the greater the strategic tilting towards growth assets, the greater the potential for reliance on external managers including CIVs, and therefore the greater the exposure to incurring the actual costs of prescribed exits.

38. For a “point in time” reference point, it is worth noting that as at 31 December 2015, ACC held approximately \$650m¹¹ through listed and unlisted CIVs, representing 1.91% of the combined value of ACC’s investment portfolio. At NZSF, CIVs comprised 4.2% of the fund as at 31 December 2015, or approximately \$1.2b.¹² While break fees will vary by fund, if one assumes break fees of approximately 1% of funds invested, the exit costs could be significant.

Value Leakage

39. By forcing the divestment of particular investments within a prescribed timeframe, there could be cases of value leakage due to the inability of ACC or NZSF to choose the optimal timing for that exit, based on market conditions.

40. By way of illustration, we look at the shift the value of \$10,000 invested in Orbis Global Equity Fund over the last 5 years. In 2011, the peak to trough variance was 21.3%, and in the last 12 month period, the peak to trough variance was 9.2%. Considering this level of volatility, being forced to exit a c.\$500m position in Orbis at an inopportune time could translate to significant loss of value.

¹¹ Excludes investments in listed entities that invest in real estate, infrastructure assets, public-private partnerships and fixed interest securities

¹² Excludes investments in entities that invest in real estate, life settlements or catastrophe bonds / natural catastrophe reinsurance

• Clarification: “strategic tilting” should be replaced with “allocation”.

Rise and Decline of NZ\$10,000 invested in Orbis Global Equity Fund (30 Jun 2005 - 31 Mar 2016)



Opportunity Cost

- 41. If ACC and NZSF were prevented from investing in CIVs (where Direct Exclusion Lists cannot be enforced), then they would lose full access to the available pool of fund managers. This would include losing access to some of those fund managers that deliver in the top quartile of returns. Or, as in the case of global macro strategy managers, there may be no alternative ways of accessing certain investment strategies. Over time this would result in an opportunity cost to ACC and NZSF with real implications on the performance of their portfolios.
- 42. By way of illustration, there is a differential of nearly 2% between the median 5 year return of the top quartile and second quartile of global equities fund managers.

5 Year Return (p.a.) as at 12/04/2016 for US based Global Equities Funds		
Quartiles	Range	Median
1st Quartile	11.11% - 7.01%	7.92%
2nd Quartile	6.99% - 5.80%	6.27%
3rd Quartile	5.79% - 4.39%	5.28%
4th Quartile	4.38% - (1.43%)	2.63%

Source: Morningstar.com

Commentary

- 43. If mandatory divestment policies were imposed on the Funds in relation to their holdings in CIVs, this would result in potentially material costs. Significant further analysis would be required if such a policy was to be considered.

Recommended Action

We recommend that you:

- a **note** the contents of the report, and
- b **provide** feedback on the report as necessary

Craig Weise
Manager, Commercial Operations – Strategy and Policy

Hon Bill English
Minister of Finance

Hon Nikki Kaye
Minister for ACC

RELEASED UNDER THE
OFFICIAL INFORMATION ACT